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No. _____

In The

Supreme Court of the United States

October Term, 1995

QANTAS AIRWAYS LIMITED,
a foreign corporation,

Petitioner,

v.

THE UNITED STATES,

Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeal For The Federal District

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

(1) Whether a statute that exempts from taxation "any" source of a foreign government's income may be interpreted by a regulatory agency to exempt only the non-commercial income of a foreign government instrumentality.

(2) Whether a court may rely solely on the existence of alternative dictionary definitions of a statutory term, eschewing historical and contextual statutory analysis, to conclude that a statute is ambiguous, thus requiring a court to give deference to a regulatory interpretation of the statute under this Court's decision in *Chevron, U.S.A. v. Natural Resources Defense Council.*

(3) Whether a regulatory agency's underinclusive definition of a statutory term, even if reasonable in the abstract, constitutes a usurpation of legislative authority when the statute itself suggests no such limiting construction.

(4) Whether the ordinary rule of judicial deference to regulatory interpretation of ambiguous statutory terms must give way to strict construction when the statute concerns the scope of foreign sovereign immunity, a subject that is uniquely the prerogative of the legislative branch.

(5) Whether Qantas Airways Limited, an instrumentality of the Australian government, could be treated by regulatory agencies as a foreign government for the purposes of some statutes but not others.

PARTIES

The parties in this case are petitioner Qantas Airways Limited and respondent United States. The only current parent companies, subsidiaries (other than wholly owned subsidiaries) and affiliates of petitioner which have issued shares to the public are: (a) British Airways PLC and (b) Air New Zealand Ltd.

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REPORTED OPINIONS IN THIS CASE

The opinion of the Court of Appeals was filed on August 3, 1995 and is reported at 62 F.3d 385. *See* Appendix at 1-11 (hereinafter "App. 1-11"). It is additionally reported at 76 A.F.T.R.2d 95-5778 and at 95-2 USTC P 50,421.

The opinion of the Court of Federal Claims was filed on March 28, 1994 and is reported at 30 Fed.Cl. 851. *See* App. 12-41. It is additionally reported at 73 A.F.T.R.2d 94-1572 and at 94-1 USTC P 50,156.

JURISDICTION

The Court of Appeals for the Federal District issued its opinion and entered judgment on August 3, 1995. App. 57. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTE AND REGULATIONS

The statute at issue is 26 U.S.C. § 892 (1985) *amended* 1986. The regulations at issue are subsections (a) and (b) of Treasury Reg. § 1.892-1 (1985) (26 C.F.R. § 1.892-1(a) and (b) (1985)). The text of these statutory and regulatory provisions appears in the Appendix. *See* App. 59-61.

STATEMENT OF THE CASE

Petitioner Qantas Airways Limited ("Qantas"), an acknowledged instrumentality of the Australian Government, was denied an income tax exemption which, by the

terms of the statute, applied to "any" source of foreign government income. The exemption was denied on the basis of a Treasury Department regulation which, without congressional authorization, reduced the scope of the exemption to only non-commercial, investment sources of income. Qantas seeks review of the decision of the Court of Appeals which upholds the validity of this regulation.

A. Status of Qantas As a "Foreign Government"

Qantas operates a national airline that flies throughout the world. From 1947 through 1993, Qantas was wholly owned and actively controlled by the Australian government. App. 2. Classifying Qantas as a "Government Business Entity," and its "flag carrier," the Australian government used its national airline to promote tourism and other national economic and political objectives. App. 14.

There was no dispute below that the Australian Government itself controlled Qantas' operations. App. 29. Qantas received all its operating capital from the Australian government. In fact, these capital outlays were part of the government's annual budget and Qantas had to receive approval for its capital requirements years in advance. The Prime Minister appointed the Board of Directors and the Minister of Transport closely supervised the airline's management. The Australian government's approval was required for all major business and investment decisions.

B. The Tax Exemption Created By Congress To Protect All Income of Foreign Governments

After the First World War and in a deliberate policy effort to stimulate foreign economies, Congress passed the War Revenue Act of 1917. Section 30 of that Act provided that certain income of foreign governments earned in the United States was exempt from tax. The relevant language provided:

> [N]othing in Section II of the [Income Tax Act of 1913] or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of monies belonging to foreign governments.

War Revenue Act, § 30, Ch. 63, 40 Stat. 300, 337 (1917).

Congress soon decided to extend further protection from tax liability to foreign governments doing business in this country by making the foreign government tax exemption complete. In the Revenue Act of 1918, Congress provided that, in addition to the previously specified sources of exempt income, a foreign government would be exempt from tax on income "from any other source within the United States." Revenue Act of 1918, § 213(b)(5), Ch. 18, 40 Stat. 1057, 1065-66 (1919).[1]

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[1] The House of Representatives Committee Report for section 213(b) of the Revenue Act of 1918 emphasized the legislative policy to extend to foreign governments a *blanket* exemption of income from any domestic source, investment or otherwise:

> Under present law it is not necessary to include in gross income the income of foreign governments

Language identical to that used in the Revenue Act of 1918 appeared in each Revenue Act through the 1938 Act and in the Internal Revenue Code of 1939. The 1939 Code was modified in 1945 to include the international organizations in the exemption and was reenacted with slight change in form as Section 892 of the Internal Revenue Code. This section, which governed the tax years in question in the instant case, provided:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments or by international organizations or from interest on deposits in banks in the United States of monies belonging to such foreign government or international organizations *or from any other source within the United States*, shall not be included in gross income and shall be exempt from taxation under this Subtitle.

26 U.S.C. § 892 (1985), *amended* 1986 (emphasis added).

> received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks of the United States of monies belonging to such foreign governments. *The proposed bill, in addition to providing that the aforementioned income shall not be included in gross income, provides that income of foreign governments from any other source within the United States shall not be so included.*

H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918) (emphasis added).

C. The Original and Correct Inclusive Regulatory Interpretation of "Foreign Government" and the Later Restrictive Interpretation of that Statutory Term

Initially, the agencies administering § 892 correctly applied that absolute tax exemption to instrumentalities of foreign governments regardless of their organizational form or the character of their income. In 1920, for example, the Bureau of Internal Revenue ("Bureau") granted the exemption to the Commonwealth Bank of Australia, even though the bank was established as a separate corporation. O.D. 628, 1920-3 C.B. 124, *revoked* I.T. 3789, 1946-1 C.B. 100, *obsolete* Rev. Rul. 69-45, 1969-1 C.B. 313. In that same year, the Bureau declared that a foreign government would not be subject to tax and income derived from the operation of its shipping vessels through agents in the United States. O.D. 515, 1920-2 C.B. 96, *obsolete* Rev. Rul. 68-575, 1968-2 C.B. 603. In 1946, the United States Tax Court reinstated the exemption to a corporation owned by Chile after the Commissioner of Internal Revenue had attempted to withdraw it. *Vial v. Commissioner of Internal Revenue*, 15 T.C. 403, (1950), acquiesced 1952-1 C.B. 4.

This early application of the § 892 tax exemption broadly to corporations and other business entities owned by foreign governments was in line with Congress's view of foreign governments as eventually expressed in the Foreign Sovereign Immunities Act ("FSIA") of 1976. 28 U.S.C. § 1602 *et seq.* The FSIA defines a "Foreign State" as including "instrumentalities" of the

foreign state, "a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof, . . . " 28 U.S.C. § 1603(b).

In the decades following the *Vial* decision, the regulatory interpretation of the scope of the foreign government exemption took various turns. In the 1950's, the Bureau appeared to narrow its interpretation of the § 892 exemption by withholding it from government owned corporations. Nonetheless, the Bureau continued to apply the exemption to the commercial income of business entities which it deemed to be foreign governments. For example, in 1952, the Bureau held that a railway owned and operated by a foreign government qualified for the exemption because the railway system was "so closely integrated with the executive arm of [the foreign] government as to be part thereof . . . " I.T. 4082, 1952-1 C.B. 69, *obsolete* Rev. Rul. 70-293, 1970-1 C.B. 282.

In the 1970's, the Internal Revenue Service expanded the regulatory interpretation of § 892 by once again extending the exemption to corporations owned by foreign governments, but this time only with respect to their non-commercial income. Rev. Rul. 75-298, 1975-2 C.B. 290.

Finally, in 1980, almost seventy years after the enactment by Congress of the broad tax exemption for foreign government income derived from "any" source, the Treasury Department promulgated regulations which radically limited the scope of the exemption to "investment sources" of income only. 26 C.F.R. § 1.892-1(a)(2) (1985); *see* App. 60. The regulations implemented this limitation on sources of exempt income by defining a "foreign government" as the "integral parts or controlled entities of a

foreign sovereign *to the extent not engaged in commercial activities.*" 26 C.F.R. § 1.892-1(b)(1) (1985) (emphasis added); *see* App. 60.

D. The Present Dispute Relating To Qantas' Income Tax

Qantas filed United States income tax returns for the tax years ending March 31, 1983, 1984, and 1985, reporting a total tax liability of $1,843,439.22. Qantas later filed amended returns for these three years seeking refunds of all taxes paid. One ground for the refunds sought was the foreign government exemption of § 892. Qantas maintained that, as a "controlled entity of a foreign sovereign,"[2] it qualified as a "foreign government" under the regulations. Qantas further maintained that it was unnecessary to determine whether its income was from non-commercial, investment sources because the intent and plain meaning of the statute was to provide a complete income tax exemption to qualifying foreign government

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[2] The regulations for § 892 defined a "controlled entity" as "separate in form from a foreign sovereign" but with the following characteristics:

> (i) it is wholly owned and controlled by a foreign sovereign . . . ; (ii) it is organized under the laws of the foreign sovereign by which owned; (iii) its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) its assets vest in the foreign sovereign upon dissolution.

26 C.F.R. § 1.892-1(b)(3) (1985); *see* App. 61. It has never been disputed that Qantas satisfied this definition during the tax years at issue.

entities regardless of the source of their income. App. 29-30.

The Internal Revenue Service conceded that Qantas was a controlled entity of Australia, within the meaning of the regulations, but decided that the income at issue was from commercial activities. Relying on the regulatory definition of "foreign government" that selectively defined "foreign governments" by the character of their income rather than their organizational status, the Service denied Qantas the requested refunds. App. 43, 45-46.

Under 28 U.S.C. § 1346(a)(1) and 28 U.S.C. § 1491, Qantas filed the present action in the United States Court of Federal Claims on March 10, 1989.

E. The Reasoning of the Courts Below

The Court of Federal Claims conducted a trial and took testimony concerning the character of Qantas' income derived from activities in the United States. At trial, Qantas argued *inter alia* that the § 892 exemption should dispose of the case in its favor as a matter of law. In a 28-page ruling, the trial court agreed and held that "Treas. Reg. section 1.892-1 (1982) was invalid insofar as it purported to limit the availability of the exemption to income derived from investment activities." App. 13.

The trial court found that between 1918 and 1986, Congress had consistently and repeatedly made it clear that the "or from any other source" language in § 892 was intended to provide foreign governments with a complete exemption from taxation on all sources of income. App. 32-36. The court found it particularly significant that the

language at issue in former § 892, originally applicable to both foreign governments and international organizations, still appears in amended § 892, is still applicable to international organizations, and is still interpreted by Congress as providing a complete exemption from taxation on all sources of income. App. 35-36. The court reasoned that the limitation of the § 892 exemption to income from investment sources was directly contrary to these clear statements of Congressional intent, and therefore "not sustainable as a valid interpretation of the statutory language in effect during the years at issue." App. 41.

On appeal, the Court of Appeals for the Federal Circuit reversed. App. 2. The Court of Appeals ignored the trial court's analysis of the intended legislative effect of the "or from any other source" language, and of the early application of the statute to controlled entities. Instead, the Court of Appeals focussed only on whether Qantas qualified for the exemption under the regulatory definition of "foreign government." The Court of Appeals recognized that Qantas was a "controlled entity" (App. 7) but remanded to the trial court for a further determination as to whether the income at issue came from non-commercial, investment sources as required by the regulation. App. 10-11.

The Court of Appeals acknowledged that "the Secretary's regulation may, in its effect, limit sources of excepted income by defining what entities qualify for the statutory exemption." App. 10. Nevertheless, the Court of Appeals held that it was reasonable for the *Secretary of the Treasury* to limit the scope of the statute in this manner.

App. 10. The Court of Appeals reasoned that the statutory term "foreign government" was ambiguous and that the regulation should be deferred to as a reasonable interpretation of an ambiguous statute. App. 7-9.

In determining that the term "foreign government" was ambiguous, the Court of Appeals failed to engage in any meaningful examination of the history or context of the statute. Instead, the Court resorted to the dictionary for its statutory construction. Quoting a dictionary definition of the word "government" supposedly narrower than the regulatory definition, the Court of Appeals reasoned that, by including "controlled entities" within its scope, the Secretary of the Treasury "defined the term foreign governments in § 1.892-1(b) more broadly than the ordinary meaning would require." App. 8. The Court concluded that, despite the statute's "or from any other source" language, the Secretary of the Treasury could reasonably use source of income as a criterion for granting or denying the foreign government exemption to controlled entities "because nothing in the statutory language compelled the Secretary to include controlled entities within the definition of foreign governments in the first instance." App. 10.

Qantas petitions this Court for a writ of certiorari to the Court of Appeals for review of that court's judgment.

REASONS FOR GRANTING PETITION

In conflict with the rules in certain other circuits, the Federal Circuit has created a dangerous precedent as to principles of statutory construction and administrative

rulemaking powers. This important precedent from this influential Circuit on administrative and tax law now rationalizes and authorizes the usurpation by administrative agencies of two Congressional prerogatives: the power to legislate and the power to define the scope of sovereign immunity afforded to foreign nations. As will be shown below, this decision conflicts with the decisions of other U.S. Courts of Appeals and addresses important questions that must be settled by this Court. *See* Sup. Ct. Rule 10(a) and (c).

A. In Conflict With the Rules in Other Circuits, the Court of Appeals Applied a Per Se "Dictionary Rule" to Establish Statutory Ambiguity

In *Chevron, U.S.A v. Natural Resources Defense Council,* 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984), this Court established the two step approach generally applied to judicial review of administrative interpretations of statutes. First, a court is to use "traditional tools of statutory construction" to ascertain whether "Congress has directly spoken to the precise question at issue." *Id.* 467 U.S. at 842-43. If that is the case, then "the Court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* It is only when the statute is silent or ambiguous that a court may take the second and more deferential step of determining whether the agency's regulation "is based on a permissible construction of the statute." *Id.*

The *Chevron* framework is founded on the principle that Congress is the supreme branch of government for making policy choices. The policy making authority of

administrative agencies is limited to filling gaps and resolving ambiguities in statutory language in order reasonably to further the statutory scheme. *Id.* at 865-866.

In this case, the trial court properly determined that Congress had unambiguously intended § 892 to grant a complete tax exemption to a foreign government's income from *any source*. As such, the lower Court properly concluded that the regulatory limitation on this plain contextual meaning of the statute was invalid because the absence of ambiguity created no need to go beyond the first step of the *Chevron* test.

The Court of Appeals avoided this result by focussing on the meaning of the statutory term "foreign government." The Court of Appeals got past the first *Chevron* step simply by noting that "foreign government" is not defined by the statute and that it necessarily is ambiguous because the word "government" has several dictionary definitions. On that basis, the Court of Appeals proceeded with the second, more deferential *Chevron* inquiry into the reasonableness of the regulatory definition of "foreign government."

Other circuit courts have plainly held that resort to a "dictionary rule" does *not* create the statutory ambiguity necessary to satisfy the first *Chevron* inquiry. *Mississippi Poultry Association, Inc. v. Madigan*, 992 F.2d 1359, 1364, (5th Cir. 1993) *en banc* 31 F.3d 293 (5th Cir. 1994); *Maislin Industries and U.S. Inc. v. Primary Steel, Inc.*, 911 F.2d 1312, 1319 n.4 (8th Cir. 1990). In *Mississippi Poultry*, for example, the Fifth Circuit, *en banc*, invalidated an Agriculture Department regulation which allowed foreign poultry products, inspected under different inspection standards

than domestic poultry products, to be imported and sold in interstate commerce as long as the foreign country's inspection standards were determined to be "at least equal to" federal standards for domestic poultry. The language of the statute, however, required foreign poultry products to be subject to the "same" inspection standards.

Just like the Court of Appeals opinion below, the Secretary of Agriculture took solace in Webster's Third International Dictionary. The Secretary argued that deference was due the regulations because alternative dictionary definitions for the word "same" created an ambiguity in the statute. The Fifth Circuit soundly rejected this avenue to deference:

> The Secretary has proposed nothing short of a per se "dictionary rule": If a dictionary (or dictionaries) contains more than one definition that makes some sense under the statute, then it is ambiguous; hence, the agency is due deference under *Chevron*. As almost every word in the dictionary is given more than one sense-making definition, such an approach would effectively preclude courts from ever reaching, much less using, "traditional tools of statutory construction" such as canons, structure, or history, to ascertain the intent of Congress.
>
> In addition, such an approach would also effect a radical shift in power from Congress to administrative agencies, as follows: For the agency interpretation to trump Congress, the agency must be entitled to deference; for the agency to be entitled to deference, there must be ambiguity; if every word for which secondary and tertiary meanings are to be found in some

> English language dictionary is deemed to be ambiguous for *Chevron* purposes, essentially every non-technical word in every statute would have the potential of being ambiguous; consequently, the agency's choice of definition would trump Congress' word usage every time – subject only to the vague caveat that the agency's choice "makes some sense" under the statute.

Id. at 307.

Recent Supreme Court opinions address but do not settle the important and recurring question as to the degree to which alternative dictionary definitions are sufficient to establish the requisite statutory "ambiguity" under *Chevron*. *National Railroad Passenger Corp. v. Boston & Maine*, 503 U.S. 407, 118 L.Ed.2d 52, 112 S.Ct. 1394 (1992), involved a statute which gave the Interstate Commerce Commission ("ICC") the power to condemn property on behalf of Amtrak if it was "required" for intercity rail passenger service. The issue was whether the term "required" should be interpreted as "indispensable" (the Court of Appeals holding) or as "useful or appropriate" (the ICC position). The ICC cited alternative dictionary definitions of the word "required" to support its view that the word was ambiguous. The Court agreed:

> The existence of alternative dictionary definitions of the word "required," each making some sense under the statute, itself indicates that the statute is open to interpretation. [citation deleted] Few phrases in a complex scheme of regulation are so clear as to be beyond the need

> for interpretation when applied in a real context.

Id., 118 L.Ed.2d at 66. Pursuant to *Chevron*, the Court deferred to the ICC interpretation.

This Court took a seemingly different view, however, in *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*, 512 U.S. ___, 129 L.Ed.2d 182, 114 S.Ct. 2223 (1994). In *MCI*, this Court considered a statute which required communications common carriers to file tariffs with the Federal Communications Commission ("FCC"). The statute further authorized the FCC to "modify any requirement made by or under . . . this section." 47 U.S.C. § 203(a). Pursuant to this authority, the FCC issued rules which eliminated the tariff requirement altogether for those carriers without market power. The issue before the Supreme Court was whether the complete elimination of a requirement was within the scope of the statutory authorization to "modify" requirements.

The FCC, relying on the reasoning in *National Railroad*, argued that its rules were due deference under *Chevron* because one of the alternative dictionary definitions for the word "modify" included "to make a basic or important change in." Webster's Third New International Dictionary (1976). The *MCI* court rejected the idea that courts must always defer to the agency's choice among available dictionary definitions. *MCI, supra*, 129 L.Ed.2d at 190. Without setting forth a rule of general applicability in this regard, this Court in *MCI* distinguished *National Railroad* noting that it "did not rely exclusively upon dictionary definitions, but also upon contextual indications." *Id.*

The U.S. Courts of Appeals are now in conflict as to the meaning and applicability of the "dictionary rule," the contours of which have previously been left unresolved by this Court. Certain circuits apply the proper rule that alternative dictionary definitions cannot open the "ambiguity" door to compelled deference to administrative – not legislative – construction of statutory meaning. Other circuits, now including the influential Federal Circuit, establish a rule that if alternative dictionary definitions exist, this automatically reveals an ambiguity, thus requiring judicial deference to the agency's proffered interpretation.

As noted by the Fifth Circuit in *Mississippi Poultry, supra*, 31 F.3d at 307, a dictionary rule is pernicious because it results in a virtual transfer of responsibility for statutory construction from Congress, and ultimately the courts, to executive agencies who easily can find alternative dictionary definitions for most statutory language. The Federal Circuit's variant on the dictionary rule is particularly dangerous because it has the additional effect of misdirecting the court's analysis from the "precise question at issue" to a subsidiary issue (in this case the meaning of "foreign government"). In this way, the deferential analysis of the regulation's reasonableness becomes divorced from "the contextual indications" which, under *MCI*, should militate against deference. *MCI, supra*, 129 L.Ed.2d at 190.

Review of this case will allow the Court to settle this vitally important question under *Chevron* and to resolve the question ultimately left open by the *National Railroad* and *MCI* decisions on this point. Furthermore, a high Court decision in favor of Qantas will curtail the facile

use of alternative dictionary definitions as a substitute for the careful statutory analysis that should be undertaken under the first *Chevron* inquiry.

B. In Conflict with Other Circuits, the Court of Appeals' Decision Authorizes an Administrative Agency to Construe the Coverage of a Statutory Term in an Underinclusive Manner Not Reflected in the Language of the Statute Itself

Even if one accepts the Federal Circuit's premise that the term "foreign government" is sufficiently ambiguous as a result of multiple dictionary definitions that the court may proceed to the second, deferential level of the *Chevron* inquiry, the degree of deference established in the opinion below for regulatory interpretations of statutes is inconsistent with the rule in other circuits.

Regardless of what the appropriate level of judicial deference to administrative regulations may be, there is no question that the statute itself establishes a limit to that deference:

> The power of an administrative officer or board to administer a federal statute and prescribe rules and regulations to that end is not the power to make laws – for no such power can be delegated by Congress – but the power to adopt regulation to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. . . .

Manhattan General Equipment Co. v. Commissioner of Internal Revenue, 297 U.S. 129, 134 (1936). The troublesome

question raised by the Court of Appeals decision is to what extent a regulatory agency, through the exercise of its supposed legitimate authority to interpret ambiguous statutory language, can artfully avoid the limitations imposed by other, *un*ambiguous statutory language.

Having concluded that the term "foreign government" could have multiple meanings, the Court of Appeals limited its review to the question of whether the definition chosen by the Treasury Department was "reasonable." App. 9-10. The Court of Appeals acknowledged that the definition of "foreign government" adopted by the Treasury Department was underinclusive in that it "may, in its effect, limit sources of exempted income by defining what entities qualify for the statutory exemption." App. 10. But this (obviously intended) inconsistency with the express statutory grant of an absolute exemption on "any" source of foreign government income played no part in the court's reasonableness analysis.

For the Court of Appeals, the reasonableness of the regulatory definition of "foreign government" was established primarily by the fact that it was one possible definition of that term. The Court also suggested that the definition conformed with the underlying purposes of the statute, noting that "[p]resumably the Secretary viewed the non-commercial activities of controlled entities as being closely aligned to the usual functions of government." App. 10.

The Federal Circuit's approach to determining the reasonableness of regulatory interpretations is in conflict with decisions of other U.S. circuit courts of appeals. *See*,

e.g., The Progressive Corporation and Subsidiaries v. United States, 970 F.2d 188 (6th Cir. 1992) (even express delegation of rule-making authority does not authorize abrogation of express statutory terms); *Orca Bay Seafoods v. Northwest Truck Sales, Inc.*, 32 F.3d 433, 435-36 (9th Cir. 1994) (not sufficient that a regulation is "rational" in the abstract or consistent with the overall purpose of the statute).

In *Orca Bay, supra*, for example, the Ninth Circuit invalidated a Transportation Department regulation exempting large trucks from a statute which required disclosure of true odometer readings on transfers of "motor vehicles." The purpose of the statute was to protect those vehicle buyers relying on the accuracy of odometer readings. The Secretary of Transportation decided large trucks should be treated differently because he had determined that purchasers of large trucks rely more on maintenance history than mileage.

The Ninth Circuit observed that the regulation in *Orca* was arguably "reasonable," in the abstract, and in accord with the purpose of the statute. Nonetheless, the statute applied to "any" motor vehicle. The Ninth Circuit ruled that the regulatory exemption for large trucks was necessarily invalid because to ignore the statutory language "would be writing a different statute, not just construing it." *Id.* at 436.

The Court of Appeals' decision below sanctioned exactly the kind of legislation by regulation rejected by the Ninth Circuit. The use of non-commercial sources of income as an element in the regulatory definition of "foreign government" embodied a deliberate policy

choice by the Secretary of the Treasury. This may have been a reasonable policy choice to make in the abstract, and indeed, Congress *did later* make that choice by amending § 892 in 1986. The Court of Appeals, however, ruled that it was reasonable for the Secretary of the Treasury to anticipate that policy choice by six years and adopt an underinclusive regulatory definition directly contrary to the then current statute.

The Court of Appeals' holding enables an administrative agency completely to exclude a party from the benefits of a statute notwithstanding that (1) the statute itself provides no basis for such a limitation and (2) the determination essentially is one of a legislative character. This ruling thus impermissibly authorizes a regulatory agency itself to define statutory beneficiaries in an underinclusive manner – as long as the interpretation is "reasonable."

The Court of Appeals' decision does not defer; it abdicates judicial review of this statutory construction process. The Court's *Chevron* decision did not contemplate such a wholesale usurpation of Congress' legislative powers by administrative agencies. The Court of Appeals' decision endorsing this usurpation should not be allowed to stand.

C. This Court Should Establish that Deferential Judicial Review is Inappropriate Where Regulatory Interpretations Intrude upon the Power of Congress to Establish the Scope of Sovereign Immunity Available to Foreign Governments

In addition to usurping the power of Congress to legislate, the Treasury regulations interpreting former § 892 also intruded on the power of Congress to set the bounds of national jurisdiction and the immunity from that jurisdiction enjoyed by foreign sovereign nations. Only Congress had the power to limit the scope of foreign sovereign immunity and, in the area of taxation, Congress did not choose to exercise that power until it amended § 892 in 1986. This Court should make clear that statutory silence or ambiguity – ordinarily indicative of judicial deference under *Chevron* – does not give administrative agencies the power to exceed the limits of national jurisdiction or foreign sovereignty as set by Congress.

1. Reg. § 1.892-1 usurped Congressional power to establish the limits of foreign sovereign immunity

Over 175 years ago, this Court recognized that the power to tax is a key indicator of jurisdictional supremacy. *McCulloch v. Maryland*, 4 Wheat. at 433 (1819). In an exercise of this authority, Congress in 1918 provided to foreign governments an absolute income tax exemption – a principle consonant with total sovereign immunity which prevailed generally at that time.

In 1976, Congress codified a limited sovereign immunity doctrine in the Foreign Sovereign Immunities Act

("FSIA"). 28 U.S.C. § 1602 *et. seq.* Congress created a comprehensive framework "governing claims of immunity in every civil action against a foreign state or its political subdivisions, agencies, or instrumentalities." H.R. Rep. No. 1487, 94th Cong., 2d Sess. 7, reprinted in 1976 U.S. Code Cong. & Admin. News 6604, 6606; *Siderman de Blake v. Republic of Argentina*, 965 F.2d 699 (9th Cir. 1992), *cert. denied*, 113 S.Ct. 1812 (1993).

The FSIA represented an important shift in the Constitutional system of checks and balances. The "principle purpose of this bill [was] to transfer the determination of sovereign immunity from the executive branch to the judicial branch." H.R. Rep. No. 1487, 94th Cong., 2d Sess. 7, reprinted in 1976 U.S. Code Cong. & Admin. News 6604, 6606

The FSIA also expressly set the limits of foreign sovereign immunity: foreign governments and their instrumentalities, when engaged in commercial activities, could be *sued*; it did not say they could be *taxed*. Congress had already spoken on this aspect of foreign sovereignty in 1918 and the 1976 Congress again chose not to abridge the complete tax exemption which the 1918 Congress had provided to foreign governments.

Viewed against this backdrop, the Treasury Department's promulgation of Reg. § 1.892-1 in 1980 constituted a blatant usurpation of Congressional power. Although, Congress assumed power over the subject of foreign sovereign immunity, the Treasury Department later presumed without authority, to issue regulations subjecting

foreign sovereigns to taxation on income from commercial sources. This regulation defied the authority of Congress, which could have included (but did not) tax liability in the FSIA or in other legislation.

2. Absent Express Statutory Authority, An Agency's Regulation that Has An Extraterritorial Impact, Should Not Be Entitled to a Deferential Standard of Review

The Treasury Department's issuance of regulations in this case created a conflict of imperatives which it is now essential for this Court to resolve. On the one hand, this Court's *Chevron* decision provided generally for a deferential standard of judicial review for administrative regulations once the statute they interpret is determined to be ambiguous. On the other hand, it is uniquely a *Congressional* prerogative to set limits, if any, on foreign sovereign immunity and administrative regulations to that effect must be founded on specific Congressional authority.

Some circuits, such as the Federal Circuit in the case below, continue to extend judicial deference to regulatory interpretations even when they have an unauthorized impact on a foreign government's sovereignty. Others, as shown below, recognize that such deference is inappropriate when the regulation at issue will have such an extraterritorial effect. Given this conflict and the continuing importance of this issue, the Court should review this case to determine whether the rule of deference set forth in the *Chevron* opinion applies in this context.

In *Federal Trade Commission v. Compagnie De Saint-Gobain-Pont-a-Masson*, 636 F.2d 1300 (D.C. Cir. 1980), the District of Columbia Circuit had to decide whether the FTC could serve its investigatory subpoenas directly on citizens of foreign countries by registered mail, as provided in FTC regulations. The statute involved did not directly address the issue. Under a *Chevron* standard, this Congressional silence would almost certainly have resulted in judicial deference to the regulatory choice. But the *Saint-Gobain* court recognized that, without specific statutory authority, service of compulsory process on a foreign national on foreign soil was an exercise in jurisdiction beyond the competence of an administrative agency, even one as attuned to international relations as the FTC. Accordingly, the *Saint-Gobain* court held that "liberal judicial interpretations of agency power are not justified when agency action threatens to have extraterritorial, rather than merely national, impact." *Id.* at 1322.

Under *Chevron*, administrative agencies have the freedom to make policy decisions which fill the inevitable gaps and answer the inevitable silences in statutory language in a reasonable manner. This makes sense when the direct effect of those policy decisions is felt primarily within the jurisdiction of the United States government, by United States citizens to whom all sectors of that government are ultimately accountable. But when administrative policy decisions have the effect of asserting jurisdiction or sovereignty outside the United States over non-United States citizens or entities, the foundation for the *Chevron* rationale disappears.

The democratic underpinnings of the *Chevron* rule of deference should give way to the concept of comity

among sovereign nations and the realities of international relations. The very non-specific authority of the Secretary of the Treasury to "prescribe all needful rules" to carry out the purposes of the Internal Revenue Code (26 U.S.C. § 7805) simply does not embrace the *de facto* formulation of foreign policy.

Where a regulation crosses the line from having a purely domestic impact to burdening directly a foreign sovereign, petitioner asks that this Court replace the general standard of judicial deference applicable under *Chevron* with a higher level of scrutiny. This scrutiny should be designed to assure that a regulation does not exceed specific statutory authority. In the present case, for example, a regulation resulting in the taxation of a foreign sovereign would be rejected absent a statute affirmatively authorizing that result. To the extent there was statutory ambiguity or silence on the matter, the agency and the courts would be compelled to err on the side of not imposing a tax.

D. The Federal Circuit's Decision Excluding Controlled Entities Like Qantas From The Definition Of "Foreign Government" Is In Conflict With The Meaning Of That Essential Term As Applied By Other Circuits And In Other Statutory Contexts

In the process of allowing a regulatory agency to encroach on the prerogatives of Congress and on the sovereign rights of foreign nations, the Federal Circuit's decision endorsed a restrictive definition of the term "foreign government" completely at odds with the way

that concept is otherwise applied by Congress and the courts.

Congress has stated, and courts have routinely held, that corporations owned by foreign states are instrumentalities of those foreign states and, as such, enjoy the statutory privileges of sovereign immunity afforded to foreign states under federal law. 28 U.S.C. § 1603. The Federal Circuit, however, holds that an acknowledged foreign government instrumentality like Qantas is *not* a foreign government for purposes of receiving the § 892 tax exemption to the extent it earns income from commercial activities. App. 10. This artificial splitting of a government from its instrumentalities has no principled basis, has never been countenanced by Congress (even in its amendments to § 892), and is in direct conflict with other courts' interpretation of the term "foreign state" under the FSIA.

The FSIA definition of "foreign state" is of paramount importance here because it represents the only comprehensive expression by Congress of its view of what constitutes a foreign sovereign government. The FSIA defines a foreign state to include any "agency or instrumentality of a foreign state." 28 U.S.C. § 1603. The statute sets forth the standard analysis for determining whether an instrumentality of a foreign state will come within that general definition, stating essentially that it be an organ of a foreign state, a political subdivision thereof or a corporation, the majority of whose shares or ownership of interest is owned by the foreign state of political subdivision. 28 U.S.C. § 1603(b)(2).

The legislative history of the FSIA shows that Congress intended the terms "organ" and "agency or instrumentality" to be read broadly. The House of Representatives report states that:

> Entities which meet the definition of an "agency or instrumentality of a foreign state" could assume a variety of forms, including a state trading corporation, a mining enterprise, *a transport organization such as a shipping line, airline,* a steel company, a central bank, an export association, a governmental procurement agency or a department or ministry which acts and is suable in its own name.

H.R. Rep. No. 94-1487, 94th Cong.2d Sess. (1976) (emphasis added).

Decisions in other circuits routinely include foreign government owned corporate entities such as Qantas within the FSIA definition of a foreign state. *See, e.g., Atwood Turnkey Drilling, Inc. v. Petroleo Brasileiro, S.A.*, 875 F.2d 1174 (5th Cir. 1989), *cert. denied*, 110 S.Ct. 1124, 493 U.S. 1075, 107 L.Ed.2d 1030; *Carey v. National Oil Corp.*, 592 F.2d 673 (2d Cir. 1979); *Arango v. Guzman Travel Advisors, Corp.*, 621 F.2d 1371 (5th Cir. 1980) (national airline indisputably a foreign state under FSIA). The one published opinion on this subject which actually involves Qantas holds the same. *Trofi v. Qantas Airways Limited* 1992 U.S.Dist. LEXIS 10183, 23 Fed.R.Serv.3d (Callaghan) 1315 (D.C.R.I. 1992); *see also, Laroque v. Qantas Airways, Ltd.*, Nos. 88-15298, 99-15349 (9th Cir. 1990); *Kleiner v. Qantas Airways, Ltd.*, No. 90-7599 (2d Cir. 1991).

In *Trofi*, plaintiffs took a state court default judgment against Qantas after purporting to effect service by delivering their summons and complaint to the Rhode Island Secretary of State. The Court found that Qantas was an instrumentality of the Australian government and that the FSIA provided the exclusive basis for jurisdiction, if any, against Qantas. Because the plaintiffs in *Trofi* had failed to serve Qantas as required under the FSIA, there was no jurisdiction over Qantas and the default judgment was void. *Trofi, supra*, 1992 U.S.Dist. LEXIS 10183.

The *Trofi* case demonstrates that the legislative decision to grant only limited immunity from jurisdiction to commercial instrumentalities of foreign states did *not* restrict their rights and privileges as foreign sovereign entities in any other respect. Qantas was a foreign state regardless of its source of income and, consequently, the plaintiffs in that case were required to go through the statutorily prescribed procedure for service on a foreign state. Having failed to do so, they were unable to even broach the issue of limited immunity. *Id.*

The regulations at issue, and the Federal Circuit opinion upholding them, go far beyond the FSIA's straightforward approach of limiting the availability of a particular statutory privilege to an acknowledged foreign government instrumentality – they deprive that instrumentality of its governmental status altogether. The Treasury Department presumably decided that it could not take the FSIA approach and simply deny the exemption to commercial governmental instrumentalities. To do so would have been too obvious an act of legislation in conflict with the absolute exemption provided by the

statute. The indirect approach chosen by the Treasury Department, however, was no less legislative in character.

Significantly, when Congress amended § 892 in 1986 to exclude commercial income from the scope of the exemption, it adopted a framework consistent with the FSIA view of foreign sovereignty, *not* with the regulatory framework upheld by the Federal Circuit. The amended statute established a broad definition of "controlled commercial entities" as entities in which a foreign government held at least a 50% interest. 26 U.S.C. § 892. The amended statute denied the § 892 exemption to such entities, but in so doing it did *not* provide that controlled commercial entities were not foreign governments. *Id.* To do so would have created a statutory scheme at odds with the FSIA, something which Congress had no need or desire to do.

The contrast between the regulations at issue and the subsequent amendments to the statute highlights the fact that limitation of the § 892 exemption to the non-commercial income of foreign governments was a purely legislative decision. By failing to acknowledge this fact, the Federal Circuit, under the guise of deference to administrative statutory construction, has endorsed a truncated definition of "foreign government" which excludes controlled entities such as Qantas from its scope. This holding, reached through reference to dictionary definitions rather than contextual analysis, conflicts with the view of Congress and other courts that foreign government corporations are entitled to all the privileges afforded a sovereign foreign government except to the extent those privileges are specifically limited by statute.

CONCLUSION

In this case, the statute in question exempted foreign governments from taxation on income from any source – much of which obviously would result from commercial activities in this country. Under a valid regulatory interpretation and under established law in analogous areas, Qantas should have been treated as a "foreign government" under the statute. Nevertheless, the Treasury Department unilaterally deprived Qantas of this statutory benefit by issuing an unauthorized and underinclusive regulatory definition excluding commercial governmental entities from the scope of the exemption.

The Court of Appeals' decision is now the law of the Federal Circuit, a court specifically entrusted with jurisdiction over a wide range of tribunals almost exclusively devoted to reviewing decisions of administrative agencies. In order to rationalize the regulation in this case, that Court corrupted the applicable standard of judicial review and countenanced blatant usurpation of Congressional prerogatives by the Treasury Department. This Court is the appropriate forum to both remedy petitioner's specific grievance and proscribe the recurrence of the administrative and judicial action responsible. For all the foregoing reasons, petitioner respectfully requests that a writ of certiorari issue to the Court of Appeals.

DATED: November 1, 1995

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United States Court of Appeals for the Federal Circuit

94-5130

QANTAS AIRWAYS LIMITED,

Plaintiff-Appellee,

v.

THE UNITED STATES,

Defendant-Appellant.

David M. Ostrander, Cooper, White & Cooper, of San Francisco, California, argued for plaintiff-appellee. With him on the brief was *John Mahoney*.

Thomas J. Clark, Attorney, Department of Justice, of Washington, D.C., argued for defendant-appellant. With him on the brief were *Loretta C. Argrett*, Assistant Attorney General, *Gray R. Allen* and *Bruce R. Ellisen*, Attorneys. Of counsel was *Steven W. Parks*.

Appealed from: U.S. Court of Federal Claims

Judge Yock

United States Court of Appeals for the Federal Circuit

94-5130

QANTAS AIRWAYS LIMITED,

Plaintiff-Appellee,

v.

THE UNITED STATES,

Defendant-Appellant.

DECIDED: August 3, 1995

Before ARCHER, *Chief Judge*, SKELTON, *Senior Circuit Judge*, and SCHALL, *Circuit Judge*. ARCHER, *Chief Judge*.

The United States appeals the judgment of the Court of Federal Claims awarding Qantas Airways Ltd. a refund of income taxes paid on certain rental and capital gains income received in the tax years ending March 31, 1983, 1984, and 1985. *Qantas Airways Ltd. v. United States*, 30 Fed. Cl. 851 (1994). We reverse and remand.

BACKGROUND

Qantas is an Australian corporation that operates an international airline with scheduled flights throughout the world, including the United States. Qantas was wholly owned and actively controlled by the Australian government during the tax years at issue. Although Qantas operates as a separate commercial enterprise, all

dividends and assets accrue to the Australian government in the event of the company's dissolution.

Qantas' "Americas Region" is comprised of North and South America. The headquarters for the Americas Region was in San Francisco, California, where Qantas owned an office building. Qantas only used three floors of the eleven floor building and leased out the remaining space in the building to other unrelated entities at market rates. During the tax years at issue Qantas received rental income from the leased office space.

Qantas also owned twenty-five houses in Millbrae, California, a suburb of San Francisco. Qantas purchased these single family residences in 1966 to house Australian citizens working for Qantas in the Americas Region. As Qantas hired more American citizens, it had less need for the Millbrae houses. Thus Qantas decided to sell some of the Millbrae houses and to lease those houses that were not on the market at the time. During the tax years in question, Qantas sold eight of the Millbrae houses and thereby received capital gains income. From the leased Millbrae houses it received additional rental income.

Qantas filed income tax returns in the United States for the tax years ending March 31, 1983, 1984, and 1985, reporting a total tax liability of $1,843,439.22. The taxes were calculated on the rental income from the leased headquarters office space and the leased Millbrae houses and on the capital gains from the sale of eight of the Millbrae houses. Qantas later filed amended tax returns for the three years in question claiming that all of its income was exempt from taxation under 26 U.S.C. (I.R.C.) § 892 (1982), which exempted the United States income of

foreign governments and international organizations from income tax. The Internal Revenue Service denied the claim for the first year and took no action on the claims for the second and third years. Qantas filed suit in the Court of Federal Claims seeking refunds of the income taxes it had paid for the three tax years at issue.

I.

In the Court of Federal Claims, Qantas filed a summary judgment motion arguing that it was entitled to an exemption from income taxation under I.R.C. § 892 because it was a "foreign government" within the meaning of that statute. The court denied the motion, noting that Qantas "is not, in the usual sense, a foreign government. It is a commercial airline that sells its services to the general public." The court concluded that Qantas was a "controlled entity" of a foreign sovereign within the meaning of the applicable Treasury regulations interpreting I.R.C. § 892, but recognized that the regulations only exempted controlled entities "to the extent not engaged in commercial activities in the United States." Treas. Reg. § 1.892-1(b)(3) (1982). Thus, the Court of Federal Claims scheduled a trial to determine whether Qantas' income was exempt under the regulation.

Following the trial, the Court of Federal Claims issued a decision in favor of Qantas. Contrary to its summary judgment ruling, the court concluded that Qantas *did* qualify as a "foreign government" within the meaning of the statute, I.R.C. § 892. The court concluded that as a foreign government, all of Qantas' income from all sources was exempt from income taxation. The court

reasoned that Treas. Reg. § 1.892-1 (1982) was inconsistent with the plain language, origin, and purpose of the controlling statute, and was invalid to the extent it purported to limit the sources of income covered by I.R.C. § 892's exemption. The government appealed.

II.

We review issues of statutory interpretation under a de novo standard of review. *Kane v. United States*, 43 F.3d 1446, 1448 (Fed. Cir. 1994). In reviewing trial court decisions interpreting the Internal Revenue Code, deference is accorded to the Secretary of the Treasury's interpretation of the Code. *Dow Corning Corp. v. United States*, 984 F.2d 416, 419 (Fed. Cir. 1993). Our review of the Secretary's interpretation, as embodied in a Treasury regulation, is limited to the question of whether that interpretation is reasonable. *Id.* An interpretation that is plainly inconsistent with the underlying statute, however, is an unreasonable interpretation. *Id.*

I.R.C. § 892 during the tax years in question provided:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks of the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall

> not be included in gross income and shall be exempt from taxation under this subtitle.

26 U.S.C. (I.R.C.) § 892 (1982).

Thus I.R.C. § 892 provided a broad exemption to "foreign governments or international organizations" from United States income taxation. The section, however, does not define a "foreign government" for purposes of this exemption, nor does any other applicable statutory provision give such a definition.

The history of I.R.C. § 892 also sheds little light on what Congress intended by using the term foreign governments. Section 892 had its origins in the War Revenue Act of 1917, ch. 63, § 1211, 40 Stat. 300, 336-337. The original version of the statute exempted foreign governments from income taxation on certain investment income earned in the United States but it did not define foreign governments. The statute was later modified in the Revenue Act of 1918, ch. 18, § 213(b)(5), 40 Stat. 1057, 1066 (1919), broadening the exemption by adding the statutory language regarding income "from any other source." No language was added to define foreign governments and nothing in the legislative history revealed any congressional intent on its meaning.

The statute was amended again in 1945, Act of December 29, 1945, ch. 652, § 4(a), 59 Stat. 669, 670, extending the § 892 exemption to international organizations as well as foreign governments. Nothing in the 1945 amendment or legislative history defined foreign governments, although the term international organization was defined. *See* I.R.C. § 7701(a)(18).

Congress made no further amendments to § 892 until 1986, after the tax years in question. Although the provision had been the subject of several I.R.S. rulings, it was not until 1980 that the Secretary issued a regulation interpreting the statute. That regulation, Treas. Reg. § 1.892-1, included the Secretary's definition of foreign governments for purposes of qualifying for the § 892 exemption:

> (b) *Foreign government defined – (1) Classes of a foreign government.* For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

Treas. Reg. § 1.892-1(b) (1982). This regulation interpreted foreign governments to include both "integral parts" and "controlled entities" of a foreign sovereign, but qualified the definition to include them only to the extent they were "not engaged in commercial activities in the United States." Integral parts and controlled entities are defined at § 1.892-1(b)(2) and (b)(3) respectively. It is not contested that Qantas is a controlled entity within the meaning of Treas Reg. 1.892-1(b)(3) (1982).

We conclude the regulation is a reasonable interpretation of the statute. I.R.C. § 892 sets forth an exemption for foreign governments without ever expressly defining what one is. As there is no evidence that Congress intended any special definition for the term, it is proper to consider the term's ordinary meaning. The word "foreign," as used in this context, plainly means a sovereign nation other than the United States. The word "government" has several definitions, but among the

most appropriate in this context is "the organization, machinery, or agency through which a political unit exercises authority and performs functions and which is usually classified according to the distribution of power within it." Webster's Third New International Dictionary 982 (G & C Merriam Co. 1971). Nothing in this definition suggests a corporation that exists solely to operate an international airline that competes with private ones, even if the airline corporation is owned and controlled by a foreign sovereign.

The Secretary, however, defined foreign governments in § 1.892-1(b) more broadly than the ordinary meaning would require. The regulation included controlled entities, such as a government-owned corporation, within the statutory definition of foreign governments. But in the regulatory language the Secretary expressly limited the § 892 exemption only to controlled entities to the extent they are not engaged in commercial activities in the United States.

Qantas argues that once controlled entities were acknowledged to be within the statutory definition of foreign governments, I.R.C. § 892 foreclosed the Secretary from limiting the activities of controlled entities that would be considered exempt. We disagree. The statute does not require that controlled entities be covered within the meaning of foreign governments. When the Secretary defined foreign governments, he chose to include controlled entities but only to the extent they were not engaged in commercial activities in the United States. This limitation is a part of the Secretary's definition of controlled entities that may be deemed to be treated as a foreign government. We agree with the government that

this limitation is reasonable under I.R.C. § 892. Accordingly, we sustain the validity of Treas. Reg. § 1.892-1 (1982) and reverse the decision of the Court of Federal Claims.

III.

In its decision finding Treas. Reg. § 1.892-1 (1982) partially invalid, the Court of Federal Claims focused on the statutory language exempting income from foreign governments and international organizations "from any other source" from income taxation. The court reviewed the legislative history behind this language and concluded that:

> the 1918 Congress intended and subsequent bodies of Congress understood former section 892 to exempt from taxation *all* of the income earned by foreign governments within the United States, from whatever source. It is hornbook law that the Treasury has no power to promulgate a regulation which either adds an exception to or supplies an omission in a statute which it believes Congress should have included but did not. *Commissioner v. Acker*, 361 U.S. 87, 91-92 (1959). As such, the portions of Treas. Reg. § 1.892 which restricted the tax exemption of foreign governments to income from investment sources were not sustainable as a valid interpretation of the statutory language in effect during the years at issue in this case.

30 Fed. Cl. at 862.

The flaw in the court's analysis is that it assumes that Qantas is a foreign government within the meaning of the

statute in all respects. As explained above, in interpreting the statute, the Secretary chose to include controlled entities, like Qantas, within the definition of foreign governments only to the extent that they were not engaged in commercial activities in the United States. In other words, to the extent controlled entities are engaged in commercial activities in the United States, they are not treated as a part of a foreign government within the meaning of I.R.C. § 892.

We recognize the Secretary's regulation may, in its effect, limit sources of excepted income by defining what entities qualify for the statutory exemption. However, the regulation is a reasonable interpretation of the statute because nothing in the statutory language compelled the Secretary to include controlled entities within the definition of foreign governments in the first instance. Presumably the Secretary viewed the non-commercial activities of controlled entities as being closely aligned to the usual functions of government and concluded any income they produced should be exempted from taxation.

CONCLUSION

The Court of Federal Claims erred in ruling that Qantas was entitled to a refund under I.R.C. § 892 merely because it was a controlled entity as defined in Treas. Reg. § 1.892-1 (1982), notwithstanding the fact it may have been engaged in commercial activities in the United States. The Treasury regulation is a reasonable interpretation of I.R.C. § 892. Accordingly, we reverse and remand for a determination of whether Qantas' activities in the

United States are commercial activities under Treas Reg. § 1.892-1.[1]

REVERSED and REMANDED

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[1] We express no opinion on whether the "any other source" language in I.R.C. § 892 is limited to investment sources and, if so, whether Qantas' leasing and sales of real estate qualify as such. These issues should be considered in the first instance by the Court of Federal Claims if it determines that Qantas is not engaged in commercial activities in the United States and, therefore, may be treated as a foreign government under I.R.C. § 892 and the regulations thereunder.

In the United States Court of Federal Claims

No. 118-89T

(Filed: Mar. 28, 1994)

QANTAS AIRWAYS LIMITED, a foreign corporation	)	Tax; Income; Foreign Government Exemption; 26 U.S.C. § 892 (1982) Treas. Reg. § 1.892-1 (1982)
v.	)	
THE UNITED STATES	)	

John Mahoney, San Francisco, California, attorney of record for plaintiff.

Robert J. Higgins, Washington, D.C., with whom was *Acting Assistant Attorney General James A. Bruton,* for defendant.

OPINION

Yock, *Judge.*

The plaintiff in this action is an international airline owned and controlled by the Australian government. It seeks to recover over $1.8 million in income taxes it paid to the United States Government on rental and capital gains income for the tax years ending March 31, 1983, 1984, and 1985. The plaintiff alleges that this income was exempt from taxation under the former section 892 of the

Internal Revenue Code (1982)[1] the foreign government exemption, and the former section 883 of the Internal Revenue Code (1982), the exemption for income from the international operation of aircraft. Trial was held on April 20, 21, and 22, 1993, in San Francisco, California, to examine the applicability of these two provisions and to determine the validity of Treas. Reg. § 1.892 (1982).

Upon full consideration of the entire record, this Court concludes that the plaintiff's rental and capital gains income for the tax years ending March 31, 1983, 1984, and 1985 was exempt from taxation under 26 U.S.C. § 892 (1982), and that Treas. Reg. § 1.892-1 (1982) was invalid insofar as it purported to limit the availability of the exemption to income derived from investment activities.

Background

A. Factual History

The plaintiff, Qantas Airways Limited ("Qantas"), is an Australian corporation wholly owned and controlled by the Australian government. Qantas operates an international airline with scheduled flights to various destinations through the world. In the nomenclature of the

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[1] The Tax Reform Act of 1986, Pub. L. No. 99-514, § 1247, 100 Stat. 2085, 2583, amended section 892 and codified the regulatory interpretation that income of foreign governments or their controlled entities is not exempt from federal income tax if it was derived from commercial activities. Neither party disputes that the income at issue in this case would be taxable under the current enactment of section 892.

Australian government, Qantas is a "Government Business Enterprise," and the Australian government occupies the role of the sole beneficial shareholder. Although Qantas operates as a separate commercial enterprise with all of its earnings credited to its own corporate accounts, all dividends and assets accrue to the Australian government in the event of the company's dissolution.

The present dispute concerns taxes that Qantas paid on income derived from two sources in the United States for the tax years ending March 31, 1983, 1984, and 1985. The first source was the lease of excess office space in Qantas' Americas Region Headquarters. Throughout the tax years in question, Qantas' headquarters for its Americas Region (North, Central and South America) was located in an eleven-story office building at 360 Post Street, San Francisco, California. Qantas owned the building and occupied a portion of it for its own downtown ticket office and executive and other offices. Qantas leased out those parts of the building not required for its own operations to various tenants, including the Australian consulate, which occupied three floors of the building during the years at issue here. The principal tenants included several other airlines and entities involved in the travel industry, along with one or two nonrelated businesses.

Qantas charged each of its tenants based rent at the market rate and passed along any yearly increases in operating costs to each tenant pro rata through an increase in rent, depending upon the number of square feet in the building that the tenant occupied. Qantas maintained an in-house property management department to maintain the property and negotiate leases, some

of which provided for alterations to the office space to either keep an existing tenant or attract a new tenant.

The second source of income was from eight single-family residences owned by Qantas in the City of Millbrae, a suburb of San Francisco close to the San Francisco International Airport. The houses at issue are among approximately 25 single-family homes in the City of Millbrae purchased by Qantas in 1966 to house Australian nationals employed by Qantas as cabin crews and management employees in the United States. The Qantas employees did not pay rent for the use of the homes.

Starting sometime in the 1970's, Qantas changed its policy on overseas personnel and began returning its Australian employees from the United States to positions in Australia and filling their jobs here with United States citizens. As this change in personnel took place, Qantas had progressively less need for the Millbrae houses.

In the 1970's and 1980's, Qantas gradually sold off all of the houses on the open market at a rate of two or three a year. During this time, Qantas rented out some of the houses on a short-term basis to people who were not Qantas employees in an effort to minimize the possibility of vandalism and to ensure proper upkeep and maintenance. Income relating to eight of the houses, which Qantas sold at various times in the tax years ending March 31, 1983, 1984, and 1985, is at issue here. This income consists primarily of long-term capital gains, but also of approximately $10,000 received from non-Qantas personnel for short-term rentals of a few of the houses before they were sold.

Qantas filed federal income tax returns for the three years in question which reported as taxable income the rents on 360 Post Street, the rents from the short-term rentals of the Millbrae houses, and capital gains on the Millbrae houses. All three categories of income are in dispute here.

B. Statutory History

The legislative underpinnings of this case originated over seventy years ago with the passage of the War Revenue Act of 1917. Section 30 of the War Revenue Act of 1917 provided that certain income of foreign governments earned in the United States was to be exempt from taxation. The relevant language provided as follows:

> [N]othing in section II of the [Income Tax Act of 1913] or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on depostits [sic] in banks in the United States of moneys belonging to foreign governments.

War Revenue Act, § 30, ch. 63, 40 Stat. 300, 337 (1917).

Early in 1919, Congress restated and reenacted the federal income tax law in the Revenue Act of 1918, Ch. 18, 40 Stat. 1057 (1919). Section 213 of that Revenue Act expanded the foreign government exemption introduced previously in the War Revenue Act of 1917 to exempt from taxation a broader range of income. Included among

the items excluded from gross income and exempted from taxation were the following:

> The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, *or from any other source within the United States* * * * .

Revenue Act of 1918, § 213(b)(5), ch. 18, 40 Stat. at 1065-66 (1919) (emphasis added). The primary difference between this version of the foreign government exemption and the previous version enacted in 1917 was the addition of the language exempting income "from any other source within the United States." *See id.*

Language identical to that used in the Revenue Act of 1918 appeared in each Revenue Act through the 1938 Revenue Act and in the Internal Revenue Code of 1939. The 1939 Code was modified in 1945 to include international organizations in the exemption and was reenacted with slight change in form as section 892 of the Internal Revenue Code. International Organizations Immunities Act, § 4(a), ch. 652, 59 Stat. 669, 670 (1945). Aside from the inclusion of language pertaining to international organizations in 1945, the language of section 892 as it existed during the tax years at issue remained essentially unchanged since its debut in 1918. Thus, during the tax years at issue and prior to the Tax Reform Act of 1986,

section 892 of the Internal Revenue Code ("former section 892") provided the following:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of monies belonging to such foreign government or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

26 U.S.C. § 892 (1982).

C. Administrative History

Although former section 892 of the Code did not define the term "foreign government," in the early years, the Bureau of Internal Revenue ("Bureau") extended the foreign government tax exemption to organizations which were formally separate but closely affiliated with a foreign government. During these early years, the exemption was granted with no distinction between commercial or investment income. In 1920, the Bureau granted the exemption to the Commonwealth Bank of Australia, even though the bank was established as a separate corporation. O.D. 628, 1920-3 C.B. 124, *revoked* I.T. 3789, 1946-1 C.B. 100, *obsolete* Rev. Rul. 69-45, 1969-1 C.B. 313. In that same year, the Bureau declared that a foreign government would not be subject to tax on income derived from the operation of vessels owned by that government through

its agents in the United States. O.D. 515, 1920-2 C.B. 96, *obsolete* Rev. Rul. 68-575, 1968-2 C.B. 603. In 1946, the Commissioner of Internal Revenue attempted to withdraw an exemption earlier granted to a corporation owned by the government of Chile that administered development funds for the Chilean government. In one of the few reported court decisions involving former section 892, the United States Tax Court reinstated the exemption. *Vial v. Commissioner of Internal Revenue,* 15 T.C. 403 (1950), *acquiesced* 1952-1 C.B. 4.

Beginning in the 1940's, the Bureau expressed increasing concern about the nature of the organizations receiving the foreign government tax exemption and the types of income qualifying for the exemption. In 1946, the Bureau revoked its earlier position granting an exemption to the Commonwealth Bank of Australia and declared that the exemption could no longer be extended to corporations which were wholly owned by foreign governments "inasmuch as a corporation is an entity separate and distinct from its sole stockholder." I.T. 3789, 1946-1 C.B. 100. Four years later, the Tax Court tempered this principle by limiting its application to a corporation as that term is understood in the United States." *Vial,* 15 T.C. at 404. In 1952, the Bureau relied on the reasoning in *Vial* to hold that a railway system owned and operated by a foreign government qualified for the exemption because the railway system was "so closely integrated with the executive arm of [the foreign] government as to be a part thereof * * * ." I.T. 4082, 1952-1 C.B. 69, *obsolete* Rev. Rul. 70-293, 1970-1 C.B. 282. In distinguishing this case from the situation addressed six years earlier in I.T. 3789, the

Bureau explained that the railway system was not a corporation. *Id.* at 71.

In 1966, the Internal Revenue Service ("I.R.S.") stated that its new position, in light of the *Vial* decision, was that an organization separate in form and wholly owned by a foreign government was exempt under section 892 of the Code, provided it did not constitute a corporation as that term was generally understood in the United States. Rev. Rul. 66-73, 1966-1 C.B. 174, *revoked* Rev. Rul. 75-298, 1975-2 C.B. 290. The I.R.S. explained that the label "corporation" referred to an organization whose purposes, functions, and activities customarily were attributable to and carried out by private enterprise for profit in this country. *Id.*

In 1975, the I.R.S. revoked its previous Revenue Ruling and refined its position once again. The I.R.S. declared that any organization created by a foreign government, which did not engage in commercial activity in the United States on more than a *de minimis* basis, qualified for the tax exemption in section 892, provided the organization met four requirements: (1) it was wholly owned and controlled by a foreign government, (2) its assets and income were derived solely from its activities and investments and from the foreign government, (3) all of its net income was credited either to itself or to the foreign government, and (4) its investments in the United States, if any, included only those which produce passive income. *Rev. Rul.* 75-298, 1975-2 C.B. 290, *clarified*, Rev. Rul. 77-41, 1977-1 C.B. 226.

D. Regulatory History

Despite the long history of the foreign government exemption, no Treasury regulations interpreting former section 892 were promulgated until 1980. In 1980, over sixty years following the passage of the original foreign government exemption legislation, the I.R.S. published Treas. Reg. § 1.892. Among other things, this regulation sought to clarify the types of entities that would fall within the rubric of the term "foreign government" and to limit the corresponding tax exemption to income derived from investment activities, rather than commercial activities.

In accordance with the most recent position of the I.R.S., Treas. Reg. § 1.892 provided that the foreign government exemption would not be available for income derived from commercial activities. The regulation accomplished this by interpreting the "any other source" language of former section 892 as including only noncommercial or passive investment sources. Thus, subsection(a)(2) and (a)(3) of the regulation provided the following:

> (2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other securities, owned by such integral part or controlled entity, or from interest on deposits in banks of moneys belonging to such integral part or controlled entity, or from any other investment source within the United States, is generally treated as income of a foreign government, which is not included in gross income and is exempt from taxation.

> (3) *Foreign government exemption not available.* (i) Income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions.
>
> (ii) Income derived by an entity created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section is included in the gross income of the entity and taxed under appropriate Internal Revenue Code provisions.

Treas. Reg. § 1.892-1(b), (c) (1982).

In another subsection of the regulation, Treas. Reg. § 1.892 defined the term "foreign government" for the first time. While acknowledging that the term could include controlled entities of a foreign sovereign, this portion of the regulation also incorporated into the definition of "foreign government" the income source restrictions addressed elsewhere in the regulation:

> [A] foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

Treas. Reg. § 1.892-1(b)(1) (1982)

In clarifying that the foreign government exemption was available to "controlled entities of a foreign sovereign," Treas. Reg. § 1.892 recognized that the structural

form of the entity claiming the exemption was less important than the strength of its attachment to a foreign government. Subsection (b)(3) of the regulation defined "controlled entity" as follows:

> An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:
>
> (i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;
>
> (ii) It is organized under the laws of the foreign sovereign by which owned;
>
> (iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and
>
> (iv) Its assets vest in the foreign sovereign upon dissolution.

Treas. Reg. § 1.892-1(b)(3) (1982).

E. The Aftermath

Prior to 1986, Congress, through former Code section 892, had applied the very same exemption language (*i.e.*, "or from any other source") to both foreign governments and international organizations. In the Tax Reform Act of 1986, directly following the tax years at issue in this case, Congress codified the income source limitations on the foreign government tax exemption that the 1980 Treasury regulations purported to impose. The tax exemption as applied to international organizations, however, remains

the same, and now appears in a separate subsection of section 892. As it is currently enacted, section 892 reads:

> § 892. Income of foreign governments and of international organizations
>
> (a) Foreign governments
>
> (1) In general
>
> The income of foreign governments received from –
>
> (A) investments in the United States in –
>
> (i) stocks, bonds, or other domestic securities owned by such foreign governments, or
>
> (ii) financial instruments held in the execution of governmental financial or monetary policy, or
>
> (b) interest on deposits in banks in the United States of moneys belonging to such foreign governments,
>
> shall not be included in gross income and shall be exempt from taxation under this subtitle.
>
> (2) Income received directly or indirectly from commercial activities
>
> (A) In general
>
> Paragraph (12) shall not apply to any income –
>
> (i) derived from the conduct of any commercial activity

> (whether within or outside the United States),
>
> (ii) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity.
>
> (iii) derived from the disposition of any interest in a controlled commercial entity.

26 U.S.C. § 892(a) (1986).

The exemption language which now applies only to international organizations is exactly the same as the language in the former version of section 892 which applied to *both* foreign governments and international organizations. The portion of section 892 relating to international organizations currently reads:

> (b) International organizations
>
> The income of international organizations received from investments in the Untied States in stocks, bonds, or other domestic securities owned by such international organizations, or from interest on deposits in banks in the United States of moneys belonging to such international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

26 U.S.C. § 892(b) (1988). With respect to the income of foreign governments, the 1986 Act deleted the phrase "or from any other source within the United States." *See* 26 U.S.C. § 892(a)(1) (1988). In addition, the present law

includes a subsection that specifically denies an exemption to foreign governments for commercial income. 26 U.S.C. § 892(a)(2) (1986). It is for this reason that neither party disputes that under the current version of section 892 the income in question would be taxable.

Discussion

The plaintiff advances several arguments in support of its position that it is entitled to a refund of the taxes paid on income derived from the leasing of office space in the Post Street building and the rental and sale of the Millbrae houses. The plaintiff's primary argument is that pursuant to former section 892, it was qualified as a foreign government during the tax years at issue and was therefore exempt from taxation on all income earned within the United States, regardless of the source. In this regard, the plaintiff contends that Treas. Reg. § 1.892 was invalid insofar as it limited the applicability of former section 892 of the Internal Revenue Code to income from investment sources. The plaintiff also advances two arguments in the alternative. First, the plaintiff argues that even if the source limitation in Treas. Reg. § 1.892 was valid, the lease income from the Post Street building was still exempt from taxation because the leases were investments in "net leases" rather than commercial activities within the meaning of Treas. Reg. § 1.892. Second, the plaintiff argues that under former section 883 of the Internal Revenue Code, the income derived from the sale and rental of the Millbrae houses was exempt from taxation because this income was incidental to the operation to an international airline.

In contrast to the plaintiff's position, the Government asserts that Qantas did not qualify for the tax exemption under former section 892 because it was not a foreign government. Second, the Government contends that although Qantas may have qualified as a controlled entity within the meaning of Treas. Reg. § 1.892, the income at issue was not exempt from taxation under that regulation because the income was derived from commercial activities instead of investment activities. Third, the Government argues that the rental income and capital gains realized from the Millbrae residences were not exempt from taxation under section 883 because neither category of income was derived form the operation of aircraft.

As a threshold matter, this Court must determine whether Qantas qualified as a "foreign government" as that term was used in former section 892. In this Court's opinion filed September 1, 1992, denying the plaintiff's motion for summary judgment, the Court concluded that Qantas did not qualify as a foreign government under the meaning of former section 892 or the regulatory interpretation of the term as expressed in Treas. Reg. § 1.892. Upon further reflection and after additional illumination at trial, this Court now concludes otherwise.

In analyzing this issue, it is helpful to refer once again to the language of the Code provision and the regulations in question. During the tax years at issue (1983-85), section 892 read as follows:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or

> other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign government or international organizations, *or from any other source within the United States,* shall not be included in gross income and shall be exempt from taxation under this subtitle.

26 U.S.C. § 892 (1982) (emphasis added).

As discussed previously, section 892 did not define the term "foreign government." However, in the early years, the section 892 exemption was routinely extended to entities which were separate and distinct in form, but closely associated with, a foreign government. *See* O.D. 628, 1920-3 C.B. 124 (exemption granted to Commonwealth Bank of Australia even though bank was a separate corporation); *Vial v. Commissioner,* 15 T.C. 403 (1950) (exemption granted to corporation owned by the Chilean government).

The Treasury regulations adopted in 1980 included "controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States," within the definition of a "foreign government." Treas. Reg. § 1.892-1(b)(1) (1982). The term "Controlled entity," in turn, was carefully defined as follows:

> (3) *Controlled entity.* An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity

> is a controlled entity if it satisfies the following requirements:
>
> (i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;
>
> (ii) It is organized under the laws of the foreign sovereign by which owned;
>
> (iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and
>
> (iv) Its assets vest in the foreign sovereign upon dissolution.

Treas. Reg. § 1.892-1(b)(3) (1982).

The Government concedes that Qantas met the established criteria for a controlled entity of a foreign sovereign. The real contention in this case is the regulatory interpretation of the statutory language of "from any other source" and the resulting distinction between investment income and commercial income in the regulations. The 1980 regulations provided that "controlled entities" would be exempt from taxation on income derived from any "investment source." Treas. Reg. § 1.892-1(a) (1982). However, the regulations expressly denied the exemption for income derived from "commercial activities." *Id.* Under the literal terms of the regulations, then, Qantas did not qualify for the foreign government exemption to the extent that its income was derived from commercial activities.

It is the plaintiff's position that Treas. Reg. § 1.892-1 was invalid insofar as it limited the applicability of the

former section 892 exemption to income from investment sources only. Plaintiff argues that the plain words of former section 892 exempted income from *any* source, and that the portion of the regulations that purported to reduce the scope of an exemption plainly provided by statute were necessarily invalid. Upon a studied review of the legislative history before, during, and to some measure after the tax years at issue, this Court is constrained to conclude that the plaintiff is correct. Therefore, it is unnecessary to address the plaintiff's alternative theories of recovery, and the remainder of this opinion will be devoted to discussing the statutory foreign government exemption and the subsequent Treasury regulations.

As a general matter, Treasury regulations are entitled to considerable deference and are considered valid if they " 'implement the congressional mandate in some reasonable manner.' " *Rowan Cos. v. United States*, 452 U.S. 247, 252 (1981) (quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)). This general principle, however, merely sets the framework for judicial analysis; it does not displace it. *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982). As an interpretative regulation promulgated by the Treasury Department pursuant to its general rulemaking powers under 26 U.S.C. § 7805, Treas. Reg. § 1.892 is entitled to less deference than those regulations issued under a specific grant of authority. *See Rowan*, 452 U.S. at 253; *Vogel*, 455 U.S. at 24. Interpretative regulations are reasonable if they harmonize with the statutory origin and purpose. *Vogel*, 455 U.S. at 26; *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472 477 (1979). Although such a regulation is not invalid merely because

the corresponding statutory language will support a contrary interpretation, the regulation in question must be struck down if it is fundamentally at odds with the manifest congressional design. *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472, 477. Moreover, as is the case here, "if the regulation dates from a later period [than the statute], the manner in which it evolved merits inquiry." *Id.*

As will be recalled, the original tax exemption provided to foreign governments by section 30 of the War Revenue Act of 1917 was a relatively limited piece of legislation that only provided an exemption for certain types of specified investment income. *See* War Revenue Act of 1917, § 30, ch. 63, 40 Stat. 300, 337 (1917). Soon thereafter, however, Congress passed the Revenue Act of 1918, which provided that gross income would not include the income of foreign governments received from the various types of investment income previously listed in the War Revenue Act, "*or from any other source within the United States.*" Revenue Act of 1918, § 213(b)(5), ch. 18, 40 Stat. 1057, 1065-66 (1919) (emphasis added). Language nearly identical to that used in section 213(b)(5) of the Revenue Act of 1918 appeared in each successive revenue act and eventually became section 892 of the Internal Revenue Code of 1954 – the statute in effect during the tax years at issue in this case. The addition of the words "or from any other source" in the 1918 Act, however, created an ambiguity that did not exist in the previous revenue acts. By the addition of these words, the question became: Did Congress intend to exempt only *sui generis* types of investment income of foreign governments, or did it instead intend to exempt investment income *and*

also all other types of domestic income (*i.e.*, commercial income)? As with any case involving statutory interpretation, "we state once again the obvious when we note that, in determining the scope of a statute, one is to first look at its language." *North Dakota v. United States*, 460 U.S. 300, 312 (1982) (citing *Dickerson v. New Banner Inst., Inc.*, 460 U.S. 103 (1982)). "Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive." *Id.* (citing *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108, (1980). While legislative history cannot prevail over the plain meaning of a statute, if the meaning is indeed plain, courts have often held that even in the face of *apparently* unambiguous language, reference is made to the legislative history to assure that no term was used other than for its ordinary meaning. *Decosta v. United States*, 987 F.2d 1556, 1558 n.3 (Fed. Cir. 1993) (citing *Glaxo Operations UK Ltd. v. Quigg*, 894 F.2d 392, 395 (Fed. Cir. 1990) (stating that the court should resort to legislative history to determine whether there is a clearly expressed legislative intention to the contrary to the statutory language).

In this case, an examination of the legislative history relating to section 213(b) of the Revenue Act of 1918 is particularly helpful in determining Congress' intent in adding the language "from any other source." *Vogel*, 455 U.S. at 25-26. The House of Representatives Committee Report relating to section 213(b) of the Revenue Act of 1918 provides the following insight:

> Under present law it is not necessary to include in gross income the income of foreign governments received from investments in the

> United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interests on deposits in banks of the United States of moneys belonging to such foreign governments. *The proposed bill, in addition to providing that the aforementioned income shall not be included in gross income, provides that income of foreign governments from any other source within the United States shall not be so included.*

H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918), *reprinted* 1939-1 C.B. 86, 92 (Pt. 2) (emphasis added). This language provides strong support for the plaintiff's argument that in adding the "from any other source" language in the Revenue Act of 1918, Congress intended not just to broaden the foreign government exemption to income from any other *investment* source, but rather to extend to foreign governments a blanket tax exemption of income from *any domestic source,* investment or otherwise.

Still more support for the plaintiff's position can be found in the legislative history relating to section 895 of the Internal Revenue Code, a provision added to the Code in 1961 which addressed the taxation of income earned by foreign banks. The Finance Committee report on the Senate bill, which introduced section 895, discussed the state of the then present law with respect to the taxation of income earned by foreign entities:

> Under present law (sec. 881 of the Internal Revenue Code) foreign corporations not engaged in a trade or business in the United States generally are subject to flat 30-percent tax (collected by withholding at the source) from amounts received on sources within the United States in the form of interest, dividends, rents,

> salaries, and other fixed or determinable amounts. * * *
>
> [An] exception to the general rule described above exists in the case of foreign governments and international organizations of which the United States is a member. Present law (sec. 892) provides that these governments or organizations are *completely exempt from tax* in the case of income earned from sources within the United States.

S.Rep. No. 163, 87th Cong., 1st Sess. (1961), 1961-2 C.B. 351 (emphasis added). Especially notable in this description of former section 892 is the use of the phrase "completely exempt" and the lack of any reference at all to a restriction on the source of domestic income which qualified for the 892 exemption. While this statement of subsequent legislative intent is not dispositive, it indicates that forty-three years after the addition of the "from any other source" language in 1918, Congress still understood section 892 to exempt from taxation *all* of the domestic income of foreign governments regardless of the source.

The legislative history of the Tax Reform Act of 1986 reveals additional clues about the way Congress viewed the former foreign government tax exemption. As previously mentioned, prior to the passage of the Tax Reform Act of 1986, the limitations placed on foreign governments and international organizations were the same. The Tax Reform Act of 1986 went into effect after the tax years at issue, and placed upon foreign governments the income source restrictions that the 1980 regulations purported to impose. The income tax exemption for international organizations, however, was placed in a separate

subsection of section 892. The exemption language which now applies only to international organizations is identical to the exemption language which formerly applied to both foreign governments and international organizations:

> The income of international organizations received from investments in the United States in stocks, bonds, or other domestic securities owned by such international organizations, or from interest on deposits in banks in the United States of moneys belonging to such international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

26 U.S.C. § 892(b) (1988). The House Conference Report on the new section 892 legislation explains that under the law as it existed prior to the Tax Reform Act of 1986, "[c]ertain international organizations * * * are completely exempt from tax," and that the 1986 law regarding international organizations "makes no change to present law." H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. (1986), 1986 U.S.C.C.A.N. 4742, 4743. It is telling that when Congress intended to maintain a complete exemption from taxation for international organizations, it chose to retain the same "from any other source" language that had previously been used in former section 892 to exempt the income of both foreign governments and international organizations. By keeping the "from any other source" language in the context of international organizations, where it intended to grant an unqualified exemption, and

deleting the phrase in the context of foreign governments, where it intended to limit the exemption, Congress effectively reaffirmed the significance of the phrase.

Despite the apparent discrepancies between the intent of Congress as expressed in the legislative histories and the limitations on the foreign government exemption imposed by the 1980 regulations, the Government contends that the subsequent enactment of three major revenue acts after the issuance of the 1980 regulations demonstrates congressional approval of those regulations.[2] It is true, as the Government argues, that in the past, Congress at times has manifested its disapproval of Treasury regulations by amending the Internal Revenue Code to correct the misguided interpretations. However, in attempting to derive the intent of congressional inaction, it is appropriate to consider the degree of scrutiny that Congress devoted to the regulation during subsequent re-enactments of the statute. *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979). In this case, there is no evidence that Congress devoted any attention at all to the foreign government exemption in former section 892 when it re-enacted the Internal Revenue Code in 1981, 1982, and 1984. Moreover, when Congress *did* scrutinize section 892 in 1986, it clearly expressed its interpretation of the then current meaning of section 892 – an interpretation squarely at odds with

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[2] Following the issuance of Treas. Reg. § 1.892 in 1980, Congress passed the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, 95 Stat. 172; the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324, and the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

the interpretation the defendant advances. As such, it is inappropriate to place more weight on Congress' inaction with respect to former section 892 than the situation warrants.

The Government also takes the position that the legislative history of the Tax Reform Act of 1986 demonstrates congressional approval of Treas. Reg. § 1.892-1 (1982). To reiterate, the Tax Reform Act of 1986 amended section 892 by incorporating into the statute the distinction between investment and commercial income that Treas. Reg. § 1.892 purported to impose. To fully analyze the Government's argument, it is necessary to review the applicable legislative history. The Senate Report contains the following description of the law as it existed prior to the passage of the amendment:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or international organizations, or from interest on deposits in banks in the United States of money belonging to such foreign governments or international organizations, or from any other source within the United States, is not included in gross income and is exempt from U.S. income taxation (sec. 892). Regulations make clear that this exemption does not apply to any income from commercial activities in the United States (Reg. sec. 1.892-1(a)(3)). That is, the exemption extends only to investment income.

S. Rep. No. 313, 99th Cong., 2d Sess., 1986-3 C.B. 415. Another reference to the state of the law as it existed

prior to the passage of the Tax Reform Act of 1986 appears in the House Conference Report, which provides in pertinent part:

> Foreign governments are not subject to U.S. tax on income from their investments in the United States. Treasury regulations specify that income from commercial activities is not investment income and therefore is not exempt from U.S. tax.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986), *reprinted in* 1986 U.S.C.C.A.N. 4742. This Court is unable to conclude from the language of these two excerpts that Congress approved of and endorsed the interpretation of former section 892 that appeared in the 1980 Treasury regulations. Instead, the quoted language serves as little more than an acknowledgement by Congress of the existence of the Treasury regulations in question. This is especially true when one considers that in this same piece of legislation, Congress retained the "from any other source" language of the former section 892 when it wished to continue to provide an unqualified exemption for international organizations. That Congress saw fit to codify the portion of the regulation that limited the exemption of foreign governments to income earned from investment activity suggests that, although Congress agreed that such a change was desirable, it viewed the regulation as legislative in character and inconsistent with the existing law.

The Government also argues that Treas. Reg. § 1.892 was faithful to Congress' intent to deny sovereign immunity claims with respect to commercial activities. This argument is based on the restrictive theory of sovereign

immunity which the United States Department of State adopted in 1952.[3] The theory was eventually affirmed by Congress with the Foreign Sovereign Immunities Act of 1976. 28 U.S.C. §§ 1602-11 (1976). Under this theory, "immunity is confined to suits involving the foreign sovereign's public acts, and does not extend to cases arising out of a foreign state's strictly commercial acts." *Verlinden B. V. v. Central Bank of Nigeria*, 461 U.S. 480, 487 (1983). Thus, the Government argues that at the time Treas. Reg. § 1.892 became effective, July 22, 1980, the United States did not recognize sovereign immunity with respect to commercial activities.

The problem with the Government's argument is that the plaintiff's claimed exemption from taxation does not rest on a theory of sovereign immunity; it is based upon a specific provision of the Internal Revenue Code that was in place during the tax years at issue. Although the Treasury regulations promulgated in 1980 might have been more consistent with this country's foreign policy position as codified by Congress in the Foreign Sovereign Immunities Act, the intent of Congress regarding matters of taxation as expressed in former Code section 892 remained on the books. The passage of the Foreign Sovereign Immunities Act in 1976 did not "trump" those sections of the Internal Revenue Code which, on a policy level, might have been somewhat inconsistent with the

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[3] This was accomplished by letter dated May 19, 1952, from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman, which is reprinted in 26 Dept. of State Bull. 984-85, and in *Alfred Dunhill of London, Inc. v. Cuba*, 425 U.S. 682, 711-15 (1976) (Appendix 2 to opinion of Justice White).

general scheme of sovereign immunity. If Congress wanted to revise the law regarding the taxation of foreign governments to coincide with the new restrictive theory of sovereign immunity, it was up to Congress to do that. As discussed, in 1986, Congress did exactly that. However, prior to 1986, the state of the law, as expressed in former Code section 892, was that the income of foreign governments derived from *all* sources within the United States was completely exempt from taxation.

The issue in this case is not whether it would have been more desirable, prior to 1986, to tax the corporate income of foreign governments derived from sources within the United States in the same manner that the United Sates taxes the income of its own domestic corporations. Few would argue that this would not have been more fair. The issue, instead, however, is whether Treas. Reg. § 1.892, was consistent with the plain language, origin, and purpose of former Code section 892. This Court believes that it was not. It is true that Congress ultimately decided in 1986 to codify the portions of Treas. Reg. § 1.892 that excepted from the foreign government exemption income derived from commercial sources. The power to legislate, however, is the sole province of the Congress. The power of the Treasury to administer a federal statute and to prescribe rules and regulations is not the power to legislate, but rather the power to adopt regulations to carry into effect the will of Congress as expressed by statute. *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936). "A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity." *Id.*

In sum, this Court believes that, as evidenced by the legislative history pertaining to the taxation of foreign entities before, during, and after the tax years in question, the 1918 Congress intended and subsequent bodies of Congress understood former section 892 to exempt from taxation *all* of the income earned by foreign governments within the United States, from whatever source. It is hornbook law that the Treasury has no power to promulgate a regulation which either adds an exception to or supplies an omission in a statute which it believes Congress should have included but did not. *Commissioner v. Acker*, 361 U.S. 87, 91-92 (1959). As such, the portions of Treas. Reg. § 1.892 which restricted the tax exemption of foreign governments to income from investment sources were not sustainable as a valid interpretation of the statutory language in effect during the years at issue in this case.

CONCLUSION

For all the reasons stated above, the plaintiff prevails in this action and is entitled to a refund of the amount paid pursuant to the dispute herein. In the event the parties are unable to stipulate as to the exact amount of the refund due the plaintiff within 30 days, further proceedings will be scheduled.

Each party will bear its own costs.

In the United States Claims Court

No. 118-89T

(Filed: Sep. 1, 1992)

QANTAS AIRWAYS LIMITED,)
)
a foreign corporation)
)
v.)
)
THE UNITED STATES)
)

John Mahoney, San Francisco, California, attorney of record for plaintiff.

Robert J. Higgins, Washington, D.C., with whom was *Assistant Attorney General Shirley D. Peterson,* for defendant.

OPINION

Yock, *Judge.*

This tax refund suit is before the Court on the plaintiff's motion for summary judgment, pursuant to Rule 56 of the Rules of the United States Claims Court. For the reasons set forth below, the plaintiff's motion for summary judgment is denied.

Facts

The plaintiff, Qantas Airways Limited (Qantas), is an Australian corporation wholly owned and controlled by

the Commonwealth of Australia. It is considered a "Government Business Enterprise" by the Australian government. Qantas operates as a separate commercial enterprise, and its earnings are credited to its own corporate accounts. However, all dividends and assets accrue to the Australian government, the sole beneficial shareholder, in the event of the company's dissolution.

The dispute centers on income taxes Qantas paid in connection with its business activities in California for the three tax years ending March 31, 1983, March 31, 1984, and March 31, 1985. Throughout the three years in question, Qantas owned an eleven-story office building on Post Street in San Francisco and several residences in Millbrae, California. However, Qantas's operations did not require the complete use of these buildings, and it decided to lease those residences and the parts of the office building not occupied by Qantas personnel. The Internal Revenue Service (IRS) taxed the income Qantas received from the leases during the three tax years at issue. Qantas paid the income taxes and sought a refund, which the IRS denied. Also, during this time, Qantas sold several of the Millbrae residences as its need to house employees changed. Qantas paid tax on the capital gain income from the sale of the homes and sought a refund, which the IRS also denied.

Qantas alleges that, as a foreign corporation which is wholly controlled by a foreign government, it is exempt from taxation on all income earned within the United States, regardless of its source, based on 26 U.S.C. § 892

(1982) (former law).[1] Accordingly, Qantas seeks a refund of $1,800,000 in taxes paid on office rental income, home rental income, and capital gain income during the three tax years at issue.

Discussion

"Summary judgment is appropriate when there are no genuine issues of material fact in dispute and the moving party is entitled to judgment as a matter of law." *GAF Corp. v. United States*, 19 Cl. Ct. 490, 496 (1990), *aff'd*, 932 F.2d 947 (Fed. Cir. 1991), *cert. denied*, 117 L. Ed. 2d 131 (1992). The moving party, in this case the plaintiff, has the burden of establishing that there are no genuine issues of material fact, *Celotex Corp. v. Catrett*, 477 U.S. 317, 321 (1986), and that it is entitled to judgment as a matter of law. *GAF Corp.*, 19 Cl. Ct. at 496. For the following reasons, this Court finds that the plaintiff has not met its burden of establishing that it is entitled to judgment as a matter of law.

The relevant section of the Internal Revenue Code, 26 U.S.C. § 892 (1982) reads as follows:

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or

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[1] The Tax Reform Act of 1986, Pub. L. No. 99-514, § 1247, 100 Stat. 2085, 2583, amended section 892 and codified the regulatory interpretation that income of foreign governments, international organizations, or their controlled entities, is not exempt from federal income tax if derived from commercial activities.

> other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations *or from any other source within the United States*, shall not be included in gross income and shall be exempt from taxation under this subtitle. [Emphasis added.]

The plaintiff contends that the phrase "from any other source within the United States" in section 892 exempts from taxation *all income* a foreign government receives in the United States, and, thus, plaintiff's income from the rental of office space and the sale of homes in California should not have been subject to income tax by the IRS. Since the Treasury regulation which interpreted this section, however, contradicted the plaintiff's interpretation of the statute, the plaintiff argues that the Treasury regulation is simply invalid as being inconsistent with the statute. The regulation at issue, Treas. Reg. § 1.892-1 (1982) (26 C.F.R.) states in subsection (a)(2) that the income of a foreign sovereign from "any other *investment* source within the United States" is exempt from taxation, and subsection (a)(3)(i) further directs that "[i]ncome derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States *is not* income of a foreign government for purposes of the exemption from taxation provided in section 892." (Emphasis added.) Finally, the plaintiff avers that there can be no dispute that Qantas is a foreign government entity.

The Government counters that Treas. Reg. § 1.892-(1)(a) (1982) (former regulation), promulgated to

interpret 26 U.S.C. § 892, limits the exemption from taxes to investment income earned by foreign governments and does not extend the exemption to income earned from commercial activities. The defendant avers that, under the doctrine of statutory construction known as *ejusdem generis*, the general words in the statute, "from any other source," apply only to things of the same general class as the items which were specifically enumerated. Since the items specifically enumerated in section 892 at issue were types of investment income, the income "from any other source" means income from any other investment source. The defendant points to the Treasury regulation interpreting this provision, which adopts the same view. Thus, the defendant concludes that since the statute does not grant the plaintiff a blanket exemption from all income (*i.e.*, that which is commercial), the Treasury regulation is valid because it is consistent with the statute, and the plaintiff's summary judgment motion therefore must be denied.

For the reasons stated herein, this Court finds that the defendant has the better of the arguments. The plaintiff bears a heavy burden in proving the invalidity of a regulation, especially in the area of federal taxation, because:

> [T]he agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems. Indeed as early as 1918, Congress expressly authorized the Commissioner "to make all needful rules and regulations for the enforcement" of the tax laws. * * * this Court has long recognized the primary authority of the

> IRS and its predecessors in construing the Internal Revenue Code * * * . [Citations omitted.]

Bob Jones Univ. v. United States, 461 U.S. 574, 596 (1983). After careful review, this Court cannot say that, based on the pleadings, affidavits, depositions, and admissions before it, the plaintiff is entitled to judgment as a matter of law.

Two questions arise in the interpretation of section 892. First, what type of entity qualifies as a "foreign government," and second, how broad a construction should the phrase "from any other source within the United States" receive? Therefore, this Court will first inquire into the meaning of the term "foreign government" as it was used in section 892 and then consider the proper construction of the phrase "from any other source" in that section.

On its face, section 892 applies only to foreign governments, and the plaintiff is not, in the usual sense, a foreign government. It is a commercial airline that sells its services to the general public. However, plaintiff claims that the IRS has routinely extended the tax exemption for foreign governments to organizations, like itself, which are separate from, but otherwise closely linked to, a foreign government. In support of this contention, plaintiff cites to several revenue rulings and a case in the United States Tax Court, which extended this exemption to certain foreign organizations.

The Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919), in section 213(b)(5) stated that the income of foreign governments received from investments or any other source within the United States should not be included in

gross income. Since a regulatory interpretation is appropriate when statutory language is stated in general terms, *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 114 (1939), this Court has undertaken an examination of relevant revenue rulings and court cases after the enactment of the Revenue Act of 1918 to determine the scope of the term "foreign government." Based on this examination, it does not appear to this Court that such status was *routinely* accorded to such organizations, as plaintiff contends. Instead, it appears that, generally, there was a careful analysis of the form and the function of the organizations to see if they served primarily governmental roles.

An early ruling, O.D. 182, 1 C.B. 90, issued in 1919, stated that the tax exemption applied to foreign delegates to the United States who were representing their country in connection with an agreement with an executive agency involving flour sales to the foreign country. Similarly, O.D. 515, 2 C.B. 96 (1920), exempted income arising from vessels owned by foreign governments and run by their agents. These two rulings are rather terse and do not reflect an expansive reading of the phrase "foreign government," but none was called for because the activities did not involve foreign-owned corporations and, thus, did not affect the scope of the term "foreign government." However, another ruling, O.D. 628, 3 C.B. 124, issued in 1920, examined the issue more deeply. The Commonwealth Bank of Australia sought an exemption

on the grounds that it was a governmental agency. This exemption was granted on the basis that:

> The Commonwealth Bank of Australia was established by an act of the legislature of Australia, which provided that the appointment of the governor of the bank and the control of its affairs should be vested in officials of the Government; that the capital necessary for its operations should be supplied solely by the sale of interest-bearing obligations, not entitling the purchaser thereof to any interest in the bank or to any share in its profits, the issuance and sale of which are to be controlled by the Governor General of the Commonwealth; that the securities so issued are guaranteed by the Commonwealth; that the Commonwealth is exclusively entitled to any profits of the bank and is the guarantor of its debts.

O.D. 628, 3 C.B. 124, 125. This detailed description shows that the bank was clearly a government-run entity, and it does not indicate that the bank engaged in any commercial activities in the United States. Also, this tax exemption for Commonwealth Bank was revoked in a later ruling, I.T. 3789, 1946-1 C.B. 100 (1946), on the grounds that a corporation, although wholly owned by a foreign government, is an entity separate and distinct from its sole stockholder and, thus, does not qualify for the "foreign government" exemption.

The United States Tax Court also considered the issue of whether a corporation is a part of a foreign government or is a separate instrumentality in *Vial v. Commissioner*, 15 T.C. 403 (1950). The corporation in question was

created under the laws of Chile for the purpose of developing and implementing a plan to promote national production. Under Chilean law, such a corporation has no stock or shareholders, and it exercises governmental powers and has a public function. The Tax Court found that the entity was not a corporation as the term is used in the United States, but rather it was part of the government of Chile because its operations were closely regulated by law, its purposes were exclusively national in scope, and it was largely supported by taxes. *Vial*, 15 T.C. at 410, 411.

Also, in a 1952 ruling, I.T. 4082, 1952-1 C.B. 69, a foreign railway system that received income from sources within the United States, and which was owned and operated by a foreign government, qualified for an exemption because it was "so closely integrated with the executive arm of the foreign government as to be a part thereof." *Id.*, at 71. The basis for this finding was that the entity was not a corporation, that it was supervised by a director general who was appointed by the president of the foreign country, that fare increases were subject to presidential approval, that it was not subject to national or local taxes in its home country, and that the employees of the entity were considered government employees.

Finally, a 1966 Revenue Ruling, Rev. Rul. 66-73, 1966-1 C.B. 174, further illuminates this issue. It states that a corporation owned by a foreign country cannot receive the foreign government exemption because the corporation is still separate and distinct from its stockholder. However, this restriction applies only to an entity which is a corporation as the term is understood in the

United States. Whether or not an entity is a corporation as the term is understood in the United States depends,

> [D]irectly upon its purposes, functions, and activities. Where its purposes, functions, and activities, taken as a whole, customarily are attributable to and carried on by private enterprise for profit in this country, it will be deemed to constitute a corporation separate from its owner even though in some instances governments also are engaged in the same or a similar activity in the United States. On the other hand, where the organization does not have purposes, functions, and activities of the type which are customarily attributable to and carried on by private enterprise for profit in this country, or, to the extent it has such purposes, functions, and activities, taken as a whole they are so circumscribed and limited that the organization does not in fact substantially resemble such a private enterprise, it will not be deemed to constitute a corporation separate from its owner, and hence will be entitled to the benefits granted by section 892 of the Code.

Id., 1966-1 C.B. at 175.

This survey of rulings on this issue suggests that, for over forty years, the regulatory interpretations of the term "foreign government" excluded foreign-owned corporations which engage primarily in nongovernmental activities similar to those activities of commercial corporations in the United States. This raises the question whether, without the expansive definition of "foreign government" in the disputed Treasury regulation, plaintiff would qualify as a "foreign government" for the purposes of the exemption due to its strongly commercial

activities, which certainly are "customarily attributable to and carried on by private enterprise for profit" in the United States. Even assuming, which this Court does not, that the Treasury regulation is invalid, plaintiff has simply failed to sufficiently carry the burden of proof on this issue to justify granting summary judgment in its favor.

Turning to the second matter, which concerns the Treasury regulation, the plaintiff makes two arguments. First, plaintiff claims that Qantas satisfies the requirements of a controlled entity and therefore qualifies as a foreign government for purposes of the exemption. Second, the plaintiff asserts that the Treasury regulation is invalid because it improperly limits the foreign government exemption to *investment* income from any other source within the United States, rather than broadly extending the exemption to income arising from any and all sources within the United States. As stated above, plaintiff carries a heavy burden in demonstrating that such a regulation is invalid. Treasury regulations are given considerable deference, *Nat'l Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 476 (1979), and the Supreme Court recognizes the primary authority of the IRS in construing the Internal Revenue Code. *Bob Jones Univ.*, 461 U.S. at 596. However, this Court will find a regulation to be invalid if it is unreasonable or plainly inconsistent with the statute it purports to construe. *Commissioner v. Portland Cement Co.*, 450 U.S. 156, 169 (1981).

Regarding the plaintiff's first contention, the regulation, Treas. Reg. § 1.892-1 (b), under the definition of a foreign government, states "[f]or purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign *to the extent not*

engaged in commercial activities in the United States." (Emphasis added.) Plaintiff maintains that it satisfies the requirements of a controlled entity, Treas. Reg. § 1.892-1 (b)(3), which are as follows:

> (3) Controlled entity. An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:
>
> (i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;
>
> (ii) It is organized under the laws of the foreign sovereign by which owned;
>
> (iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and
>
> (iv) Its assets vest in the foreign sovereign upon dissolution.

Plaintiff may well be correct in its assertion that it satisfies the four factors for a controlled entity. However, plaintiff fails to address the fact that the same provision of the regulation that qualifies it as a foreign government for the purposes of section 892 also limits the definition of a foreign government to integral parts or controlled entities to the extent these organizations are not engaged in commercial activities in the United States. Treas. Reg. § 1.892-1 (b)(1). This limitation reflects the history of rulings that this Court discussed herein, which limited the exemption for foreign governments to entities which carried out governmental, not commercial, activities.

As for the regulation's limitation of the exemption to investment income, plaintiff challenges the validity of the regulation by citing to the legislative history, such as that of the original section granting the broadened exemption, section 213 (b)(5) of the 1918 Revenue Act. The House of Representatives Committee Report states:

> Under the present law it is not necessary to include in gross income the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks of the United States of moneys belonging to such foreign governments. The proposed bill, in addition to providing that the aforementioned income shall not be included in gross income, provides that income of foreign governments from any other source within the United States shall not be so included.

H.R. Rep. No. 767, 65 Cong., 2d Sess. (1918), reprinted 1939-1 (part 2) C.B. 86 at 92. This certainly is strong support for the plaintiff's argument that the Treasury regulation is incorrect in restricting the exemption to investment income of foreign governments and that a broader construction of the phrase "from any other source within the United States" is warranted. However, this alone does not support extending the exemption to the plaintiff. While the legislative history may suggest that *all income* of a *foreign government* is exempt from taxation, plaintiff does not qualify as a foreign government either under the plain meaning of section 892 or the regulatory interpretation of the term, discussed above. Plaintiff has not directed this Court's attention to any

legislative history suggesting that Congress intended to extend this exemption to the commercial activities of foreign corporations within the United States simply because all the corporation's shares are owned by a foreign government. Thus, plaintiff has not shown that the regulation is invalid as it applies to a corporation wholly owned by a foreign government and engaged in commercial activities in the United States.

Therefore, for purposes of this motion, this Court finds that the plaintiff has failed to carry the burden of showing either that section 892 plainly grants it an exemption or that the Treasury regulation, which denies it the exemption, is plainly invalid as being inconsistent with the statute it purports to interpret as it applies to the plaintiff in its status as a corporation owned by a foreign sovereign. It is apparent that neither the section's plain meaning, legislative history, nor regulatory interpretations establish the plaintiff's position so strongly as to entitle it to judgment as a matter of law. Due to the failure of the plaintiff to meet this burden, the Court will not consider at this time the defendant's remaining arguments in support of the Treasury regulation and the denial of the exemption for income generated by commercial activities.

CONCLUSION

For the reasons stated above, the plaintiff's motion for summary judgment is denied.

The parties will complete any further discovery needed in this case on or before November 15, 1992, with the plaintiff's filing its Appendix G submissions pursuant

to the Rules of the United States Claims Court (paragraphs 11-15) on December 1, 1992. The defendant's Appendix G submissions will be due on December 20, 1992, with any responses by the plaintiff due on January 10, 1993. A final pretrial conference will be held in the National Courts Building, Washington, D.C., on January 20, 1993, with a late January or February 1993 trial in San Francisco contemplated. (Parties are to agree on the dates for trial and advise the Judge's secretary.) The final pretrial conference shall deal with:

(a) Admitting into evidence, or marking for identification, the documentary exhibits which the parties wish to offer. Legible copies of the documents should be available for opposing counsel and the judge. The judge's bench copies of the exhibits should be in a 3-ring binder, tabbed numerically, complete with index. These copies are in addition to the actual exhibits to be admitted into evidence;

(b) Date, length, and location of trial. Trial is tentatively scheduled for late January or February, 1993, and will be held in Federal Court facilities in San Francisco, California;

(c) Such other matters as will aid in the disposition of the case.

IT IS SO ORDERED.

Robert J. Yock (signed)

Robert J. Yock
Judge

United States Court of Appeals
for the Federal Circuit

94-5130

QUANTAS AIRWAYS LIMITED,

Plaintiff-Appellee,

v.

THE UNITED STATES,

Defendant-Appellant.

Judgment

ON APPEAL from the United States Court of Federal Claims

in CASE NO(S). 118-89 T

This CAUSE having been heard and considered, it is ORDERED and ADJUDGED:

REVERSED and REMANDED

ENTERED BY ORDER OF
THE COURT

DATED AUG. 3, 1995 /s/ Francis X. Gindhart
Francis X. Gindhart,
Clerk

ISSUED AS MANDATE: SEP. 25, 1995

In the United States Court of Federal Claims

No. 118-89 T

QANTAS AIRWAYS LIMITED,
A FOREIGN CORPORATION,

JUDGMENT

v.

(Filed Apr. 26, 1994)

THE UNITED STATES

Pursuant to the court's order of March 28, 1994, and the April 21, 1994, stipulation of the amount of judgment,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiff is awarded the following amounts, plus interest according to law, for the taxable years ended on March 31:

1983 $497,227.32
1984 $628,054.77
1985 $718,157.13

Each party shall bear its own costs.

David A. Lampen
Clerk of Court

April 26, 1994

By: /s/ Illegible
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see RCFC 72, re number of copies and listing of *all plaintiffs.* Filing fee is $105.00.

Internal Revenue Code, 26 U.S.C. § 892 (1985) *amended* 1986:

SEC. 892. INCOME OF FOREIGN GOVERNMENT AND OF INTERNATIONAL ORGANIZATIONS.

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks of the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

1985 Income Tax Regulations, 26 C.F.R. § 1.892-1 (1985):

§ 1.892-1. Income of foreign governments.

(a) *Manner of taxing* – (1) *In general.* Section 892 provides, in general, that the income of a foreign government from sources within the United States is excluded from gross income and exempt from taxation. Paragraph (b) of this section defines a foreign government. In particular it described the extent to which either an integral part of a foreign sovereign or an entity created by a foreign sovereign will be treated as a foreign government for purposes of section 892. To the extent that income is derived by such an integral part or entity of a foreign sovereign which does not qualify as a foreign government as defined in paragraph (b) of this section, the income is subject to taxation in accordance with appropriate Internal Revenue Code provisions.

(2) *Foreign government exemption.* The income derived by an integral part or controlled entity of a foreign sovereign from investments in the United States in stocks, bonds, or other securities, owned by such integral part or controlled entity, or from interest on deposits in banks of moneys belonging to such integral part or controlled entity or from any other investment source within the United States, is generally treated as income of a foreign government, which is not included in gross income and is exempt from taxation.

(3) *Foreign government exemption is not available.* (i) Income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions.

(ii) Income derived by an entity created by a foreign sovereign that does not qualify as a controlled entity of the foreign sovereign under paragraph (b)(3) of this section is included in the gross income of the entity and taxed under appropriate Internal Revenue Code provisions.

(b) *Foreign government defined* – (1) *Classes of a foreign government.* for purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States.

(2) *Integral part.* An integral part of a foreign sovereign is any person, body of persons, organizations,

agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. It does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity.

(3) *Controlled entity.* An entity which is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity is a controlled entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

The term "controlled entity" does not include any entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section.

* * *